



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

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[REDACTED]
United States Senate
Washington, D.C. 20510-0304

Attention: [REDACTED]

Dear [REDACTED]:

This letter is in reply to your inquiry dated March 6, 2000, on behalf of your constituent, [REDACTED]. [REDACTED] will receive a severance payment from the United States [REDACTED] upon his discharge from the [REDACTED] because of a medical disability. [REDACTED] is concerned that the severance payment will be subject to income tax withholding at a flat 28 percent rate.

Taxability of Severance Payments

Generally, gross income for federal income tax purposes includes all income from whatever source derived, unless a specific exclusion applies. Gross income does not include amounts received for personal injuries or sickness resulting from active service in the armed forces if an individual:

- was entitled to an amount on or before September 24, 1975;
- was a member or under a binding written commitment to become a member of the armed forces on September 24, 1975;
- received the amount because of a combat-related injury; or
- would be entitled to receive disability compensation from the Veterans Administration (VA) if he or she applied.

(See sections 104(a)(4) and 104(b) of the Internal Revenue Code (Code).)

In St. Clair v. United States, 778 F.Supp. 894 (E.D. Va. 1991), the taxpayer was discharged from the military and received a lump-sum disability severance payment. The VA subsequently decided that the taxpayer was entitled to disability benefits. The

taxpayer filed a timely refund claim for taxes paid on the severance payment. Because the taxpayer had received an award of VA benefits and, therefore, was an individual described in section 104(b) of the Code, the court held the disability severance payment was excludable from gross income under section 104(a)(4). The Internal Revenue Service has acquiesced in this decision.

Accordingly, to exclude disability severance payments from gross income, a taxpayer must be able to show the following: (1) he or she received a disability severance payment; (2) he or she is an individual described in section 104(b); and (3) if claiming a refund of taxes, the claim is not barred by the statute of limitations.

Withholding Requirements on Severance Pay

Regarding income tax withholding requirements on severance pay, section 3402(a) of the Code requires employers to withhold income tax on payments of “wages” made to employees. To the extent it is determined at the time of payment that a payment can be excluded from gross income under section 104(a)(4), the payment is not subject to income tax withholding. See section 31.3401(a)-1(b)(1)(i) of the Employment Tax Regulations. If it has not been established at the time of payment that the severance payment can be excluded from gross income, withholding would apply. Any payments made by an employer to an employee on account of dismissal, that is, involuntary separation from the service of the employer, constitute wages regardless of whether the employer is legally bound by contract, statute, or otherwise to make such payments. (See section 31.3401(a)-1(b)(4) of the regulations.)

Because the severance payment is paid in addition to regular wages, it will be a supplemental wage payment. If the employer identifies the amount of the supplemental wages separately from the amount of regular wages and has withheld income tax from the employee’s regular wages, the employer must withhold on supplemental wages by using one of two methods:

- (1) Add the supplemental and regular wages for the most recent payroll period of the year. Then determine the income tax withholding based on treating the total as a single payment for a single payroll period. Subtract the tax already withheld from the regular wages from the income tax withholding determined for the total payment. Withhold the remaining tax from the supplemental wages.
- (2) Withhold a flat 28 percent of the supplemental wages, without allowance for exemptions and without reference to any regular payment of wages.

An employer can elect to use either method. The 28 percent flat rate for supplemental wages was established by section 13273 of the Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66.

In summary, from the information provided by your constituent it appears the employer would be correct in withholding federal income tax from the severance payment.

This letter will be made available for public inspection after names, addresses, and other identifying information have been deleted, as appropriate, under the Freedom of Information Act.

I hope this information is helpful to you in responding to your constituent. If you have further questions, please call me or Alfred G. Kelley (Identification Number 50-03882) at (202) 622-6040.

Sincerely,

Mary Oppenheimer
Assistant Chief Counsel
(Employee Benefits and
Exempt Organizations)